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| JOSEPH STECHLER; GAIL STECHLER and STECHLER & CO., INC., f/k/a JOSEPH STECHLER & CO., INC., | UNITED STATES DISTRICT COURT<br>DISTRICT OF NEW JERSEY |
| Plaintiff(s), | |
| -vs- | Hon. Harold A. Ackerman<br>Civil Action No. 05-3485 (HAA) |
| SIDLEY AUSTIN BROWN & WOOD, LLP; R.J. RUBLE, ALPHA CONSULTANTS, INC.; ALPHA CONSULTANTS, L.L.C.; IVAN ROSS; IRWIN ROSEN; GRANT THORNTON, L.L.P.; GRANT THORNTON INTERNATIONAL ISRAEL PRESS; REFCO CAPITAL MARKETS, LTD.; and REFCO CAPITAL LLC, | **REPORT & RECOMMENDATION** |
| Defendant(s). | |

## INTRODUCTION

This matter comes before the Court on plaintiffs' application to remand this case to state court. Pursuant to Fed.R.Civ.P. 78, no oral argument was heard. After carefully reviewing the parties' submissions and the record, it is respectfully recommended that plaintiffs' motion to remand should be granted.

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## BACKGROUND

On June 14, 2005, plaintiffs Joseph Stechler, Gail Stechler, and Stechler &Co., Inc. ("plaintiffs") filed their complaint in the Superior Court of New Jersey, Law Division, Bergen County against defendants Sidley Austin Brown & Wood, LLP ("Sidley"), R.J. Ruble, Alpha Consultants, Inc., Alpha Consultants, L.L.C., Ivan Ross, Irwin Rosen, Grant Thornton, L.L.P., Grant Thornton International, Israel Press, Refco Capital Markets, Ltd. and Refco Capital LLC ("defendants").[1]

On July 11, 2005, defendant Sidley removed the case to this court. Sidley's removal petition cites 28 U.S.C. 1331 and 1441 et seq. and states that this court has original jurisdiction because plaintiffs' claims depend on the construction of federal law. Sidley contends that although no federal claims are expressly pleaded, plaintiffs' claims require the construction of federal tax law.

Plaintiffs had previously filed suit against all of the defendants named in this case (as well as other defendants), in the United States District Court for the Southern District of New York (the "SDNY action"). In an opinion and order dated April 5, 2005, Judge Scheindlin dismissed plaintiffs' RICO claims, which were the only federal claims pleaded and declined to exercise supplemental jurisdiction over the

[1]On October 17, 2005, Refco Capital Markets, Ltd. and Refco Capital LLC filed for bankruptcy and the action against them was automatically stayed.

remaining state law claims. The RICO claims were dismissed without prejudice with leave to replead them as a claim under the federal securities laws. Plaintiffs apparently decided to file the New Jersey state court action without a RICO claim instead of filing an amended complaint in the SDNY.

The crux of plaintiffs' claims is that defendants unlawfully developed and fraudulently induced plaintiffs to engage in a tax shelter, known as the Digital Options Strategy (the "Strategy"). Defendants are tax and consulting services firms, legal and financial services firms and individuals employed by them. In their 112-page, 210-paragraph complaint, plaintiffs allege nine state law causes of action including unjust enrichment, breach of contract, breach of fiduciary duty, fraud, negligent misrepresentation, professional malpractice and civil conspiracy. Plaintiffs have moved to remand this case to the state court because no federal issues are in dispute and the case arises under state law.

## FACTS

In the prolix complaint, plaintiffs allege a complex conspiracy among defendants relating to the tax shelter Strategy. According to plaintiffs, the Strategy was marketed to wealthy individuals who had realized large capital gains. The structure and details of the Strategy are quite complex and irrelevant to the instant motion. One of the purported goals of the Strategy was to generate a large capital loss which would then be used to eliminate or reduce a taxpayers capital gains, substantially reducing the tax liability.

Plaintiffs allege that defendants fraudulently induced them to participate in the Strategy by intentionally lying, hiding crucial information and also by assuring them that the Strategy would pass IRS scrutiny if they were ever audited, which plaintiffs allege defendants knew was false. Defendant Grant Thornton prepared tax returns reflecting the Strategy. Defendants Alpha and Refco assisted in implementing the transactions required to execute the Strategy. Defendant Sidley provided a purportedly independent opinion letter attesting to the propriety of the tax shelter transactions. Defendants allegedly agreed to split the fees paid by plaintiffs for participating in the Strategy.

During the later part of 2000, plaintiffs had large capital gains from the sale of certain stockholdings. Based on alleged misrepresentations of certain defendants and nonparties, plaintiffs agreed to engage in the Strategy and paid substantial fees to do so. Plaintiffs also took numerous other steps required to implement the Strategy, such as forming holding companies and transferring assets.

In November 2000, plaintiffs entered into two digital options contracts pursuant to the Strategy. Plaintiffs paid $25,000,000 for a long option and $24,500,000 for a short option. The long option provided that if the reference price of the NASDAQ 100 Index on January 19, 2001 between 9:30 and 9:45 a.m. exceeded the strike price of $3,716.84, then Refco would pay the Stechlers

$140,230,051. The short option provided that, if the reference price at the time exceeded the strike price, the Stechlers would pay Refco $138,430,056. For a variety of reasons related to those transactions, the strong likelihood is that the ultimate result of the transaction will be close to a wash. However, because of the way the transactions (which are far more convoluted than described here) are characterized for tax purposes, the Strategy participant supposedly realizes a large capital loss. In February 2001, the Stechlers received an opinion letter from Sidley attesting to the validity of the Strategy. In July 2001, plaintiffs filed a tax return for 2000 which included the artificial losses generated by the Strategy. Defendant Grant Thornton prepared the Stechlers' 2000 tax return.

In December 2000, before the Stechlers engaged in the Strategy, the IRS began an investigation into the Strategy and similar tax shelters. Nonparty DGI, the alleged originator of the Strategy, was served with an IRS request for a list of clients who had engaged in such shelters. Plaintiffs claim this was known by certain defendants and not disclosed to plaintiffs. In 2001, the IRS offered an amnesty program for individuals who had participated in the Strategy and similar shelters. In March 2002, Sidley allegedly informed the Stechlers of the amnesty program and advised them to contact their accountants to determine whether they should participate in the program. The Stechlers contacted Grant Thornton, who allegedly advised them not to participate.

On June 19, 2003, the IRS notified the Stechlers that their 2000 tax return had been selected for examination regarding the legitimacy of the Strategy. The Stechlers retained new counsel. Ultimately, plaintiffs settled with the IRS, agreeing to pay back taxes, interest and a ten percent penalty, and losing 50 percent of their deductions for fees and other out-of-pocket costs. Plaintiffs claim to have lost a significant amount of money in engaging in the Digital Options Strategy. Plaintiffs paid fees to defendants and others of at least $1,500,000. In addition to penalties and interest, plaintiffs also claim to have incurred substantial legal, accounting and other fees in connection with addressing the problems created by the Strategy. Although the breadth of the plaintiffs' allegations cannot be repeated here, the recurrent theme of the complaint is that plaintiffs were deliberately lied to, that defendants and nonparties engaged in a conspiracy to perpetrate a fraud and that professionals breached various fiduciary and other duties in the course of their dealings with the Stechlers.

## DISCUSSION

A motion to remand is governed by 28 U.S.C. 1447(c), which provides that removed cases shall be remanded "[i]f at any time before final judgment it appears that the district court lacks subject matter jurisdiction." The party removing the action bears the burden of establishing federal jurisdiction. Penn v. Wal-Mart Stores, Inc., 116 F. Supp. 2d 557, 561 (D.N.J. 2000) (citing Boyer v. Snap-On Tools Corp., 913 F.2d 108, 111 (3d Cir. 1990)). In this circuit, removal statutes are strictly construed against removal and any doubts are resolved in favor of remand. Boyer, 913 F.2d at 111 (quoting Steel Valley Auth. v. Union Switch & Signal Div., 809 F.2d 1006, 1010 (3d Cir. 1987)).

Sidley must demonstrate that the court has federal question jurisdiction over plaintiffs claims. Whether federal question jurisdiction exists is determined by examining the plaintiffs' well-pleaded complaint. Merrell Dow Pharms., Inc. v. Thompson, 478 U.S. 804, 808 (1986). Federal question jurisdiction arises where a "well-pleaded complaint establishes either that federal law creates the cause of action or that the plaintiff's right to relief necessarily depends on resolution of a substantial question of federal law." Franchise Tax Board v. Construction Laborers Vacation Trust, 463 U.S. 1, 27-28 (1983).

______No federal claims are expressly pleaded in the complaint. Indeed, upon dismissing the federal RICO claim in the SDNY action, Judge Scheindlin indicated as much in refusing to exercise supplemental jurisdiction over the remaining state law claims. However, Sidley contends that federal question jurisdiction exists because a substantial disputed question of federal law is a necessary element of the state claims pleaded.

On the day before plaintiffs filed their complaint in state court, the United States Supreme Court issued an important opinion on the so called substantial federal question doctrine. Grable & Sons Metal Products, Inc. v. Darue Eng'g & Mfg., ____ U.S. ____, 125 S.Ct. 2363, 162 L.Ed.2d 257 (2005). In Grable, the Supreme Court resolved a circuit split regarding whether a pleaded federal cause of action was required for exercising federal question jurisdiction. The Supreme Court decided that an explicit federal cause of action is not required and stated the standard as follows:

> Instead, the question is, does a state-law claim necessarily raise a stated federal issue actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance of federal and state judicial responsibilities.

Id. at 2368.

Grable involved a quiet title action filed in state court which was removed to federal court. The Supreme Court held that the interpretation of a federal statute bearing upon the quiet title action "appeared to be the only legal or factual issue contested in the case." Id. at 2368. The Supreme Court further stated that the meaning of the federal tax provision at issue in Grable was an important issue of federal law that belonged in federal court. Id. The Court also decided that the exercise of federal jurisdiction would not upset the division of labor between state and federal courts commenting: "[I]t will be the rare state title case that raises a contested matter of federal law." Id.

Sidley contends that plaintiffs' state law claims here depend on a construction of federal tax law. Sidley argues that plaintiffs' allegations can be proven only if plaintiffs can establish that their tax advice was improper under federal tax law. Therefore, it concludes all of plaintiffs' claims turn on a question of federal law and remand is appropriate. Plaintiffs counter that the case raises no substantial federal questions. Rather, plaintiffs assert the primary issues are not the meaning of federal tax law, but whether the representations and advice given to the plaintiffs were fraudulent or negligent.

Following a painstaking review of the complaint, this Court concludes that the case should be remanded to state court. None of the Grable requirements is satisfied. First, the state law claims pleaded in the complaint do not raise an actually disputed and substantial federal issue. Second, entertaining federal jurisdiction in this case would likely interfere with the balance of federal and judicial state responsibilities.

Defendants premise federal jurisdiction on the assertion that plaintiffs' claims require interpretation of federal tax law, i.e., whether the Strategy violates federal tax law. There is no question that defendants' representations regarding the validity of the Strategy under federal tax law and the reasonableness of defendants' interpretation of various IRS notices and regulations are part of this case. However, unlike Grable, the tax implications of the Strategy are not the primary focus of the complaint nor the only contested issue in the case. Plaintiffs allege, inter alia, numerous instances of intentional fraud having nothing to do with federal tax law. Many of the allegations assert that defendants lied to plaintiffs and withheld known information. For example, (1) plaintiffs allege that defendants failed to disclose the true likelihood that the digital options contracts would pay out; (2) that defendants retained virtually unlimited discretion to determine whether the digital options contracts would pay out and, therefore, they could insure that the options contract would not pay out; and (3) defendants failed to apprise plaintiffs that the digital options contract "had no reasonable possibility of a profit and that in reality the net effect of the digital options they were purchasing and selling was nothing more than a wager, like buying a lottery ticket." Complaint ¶ 22. Although too numerous to list, the complaint is filled with such allegations which do not implicate federal law.

The Complaint also includes numerous allegations of conflicts of interest and other professional negligence unrelated to the interpretation of federal tax law. For example, regarding Sidley, in addition to alleging misrepresentations, conflict of interest, et cetera, plaintiffs allege the rather mundane malpractice complaint that "at no point did Brown & Wood ("Sidley") contact the Stechlers to discuss the facts of their business, their tax situation or the Strategy." Complaint ¶ 53.

In the Court's view, the central focus of the case is not the tax implications of the Strategy, but rather the honesty and reasonableness of defendants' conduct. Stated differently, the primary issue is not the meaning of federal tax law, but whether the representations made and advice given to the plaintiffs was fraudulent and/or negligent. As the complaint is structured, the proper interpretation of federal tax law is at most a relatively minor issue, not an actually disputed and substantial one.

There is also a credible argument that any questions regarding interpretation of the tax law has been resolved. Plaintiffs' complaint cites two IRS notices, 1999-59 and 2000-44, warning about tax shelters like the Strategy which the defendants are alleged to have been aware of prior to the dealings with the Stechlers. In 2003, new IRS regulations outlawing such shelters were enacted, giving them the authority of law. Complaint ¶¶ 140-141. Thus, there is no real issue as to the legality of the Strategy. In addition, plaintiffs have already been assessed and paid the IRS. Thus, the tax law aspect of the case has been largely resolved.

The Court also finds that exercising federal jurisdiction in this case would not be consistent with congressional judgment about the sound division of labor between state and federal courts. In Grable, the Supreme Court stated that it would be the rare state title case that raised a contested issue of federal law. Grable at 2368. Allowing jurisdiction under the circumstances in this case could open the federal courts to any malpractice, breach of contract or other state law claim alleging a fraudulent or unreasonable interpretation of federal law. Plaintiffs also note that numerous suits are pending throughout the country on the tax shelter transactions done by the Sidley defendants and others and many more will be filed. Thus, plaintiffs argue that allowing jurisdiction would open the "flood gates" allowing removal or filing of claims brought by hundreds of tax shelter purchasers into federal courts. This Court agrees that the potential for shifting numerous cases to federal court is palpable because even straightforward malpractice cases may touch upon some aspect of federal law.

The parties have cited to three post-Grable district court decisions involving requests to remand similar claims by plaintiffs alleging they were victimized by financial and professional firms promoting analogous tax shelter strategies.

In Becnel v. KPMG LLP, 387 F.Supp.2d 984 (W.D. Ark. June 21, 2005), Judge Dawson denied a motion to remand a tax shelter case against various defendants including Sidley which issued a tax shelter opinion letter for a different tax shelter strategy. The Becnel court made a conclusory finding that a determination as to the legality of the tax shelter underlying the state law causes of action was essential to the determination of plaintiffs' claims. Citing Grable, the Becnel court stated "there is no good reason to deny federal jurisdiction with this dispositive and contested federal issue at the heart of the state law claim." See, Becnel 397 F.Supp.2d at 986. Becnel did not address the second aspect of the Grable analysis, whether exercising jurisdiction affected the division of labor between federal and state courts.

In Sheridan v. New Vista, L.L.C., et al., 2005 WL 2090898 (W.D. Mich. August 30, 2005), the court granted a motion to remand on nearly identical facts. In Sheridan, Judge Gordon J. Quist noted that "a defendant's unreasonable or unsupportable interpretation of federal law generally does not present a federal question or arise under federal law." Sheridan at 5. Thus, the court held that plaintiff's claims arose under state law and "the fact that they may present questions of federal tax law is not sufficient to present a substantial federal question." Id. In language that applies with equal force here, the court further stated:

> [U]nlike the claim in Grable & Sons, Plaintiff's claims [based on a tax shelter and the failure to disclose the same IRS Notices relied on in this case] do not call into question the proper interpretation of federal tax law, but rather concern the reasonableness of Defendants' interpretation of federal tax law, *i.e.*, whether Defendants knew or should have known that the Strategy was invalid under federal tax law. In other words, even if Plaintiffs are correct that the Strategy was improper and illegal as set forth in IRS notices or regulations, the relevant inquiry, as plaintiffs allege..., is whether Defendants were aware of or should have been aware that the Strategy was invalid. . .

Sheridan at 4.

> The possible consequences of federal jurisdiction in this case are much more broad [than Grable]. ...there is nothing to distinguish this case from fairly routine state law malpractice claims against attorneys, accountants, or other professionals based upon an unreasonable interpretation of federal tax or securities law. The potential for shifting the division of labor from state to federal courts is much greater in this case because if federal jurisdiction exists here, any malpractice, breach of fiduciary duty, or similar state law claim alleging an unreasonable interpretation of federal law, be it tax, securities, ERISA, etc. would invoke federal question jurisdiction. The mere presence of a federal issue should not produce such a result.

Sheridan at 4.

Finally, findings and recommendations by Magistrate Judge Janice M. Stuart in Maletis v. Perkins & Co., et al., Case No. 05-820-57 (D.Or. Sept. 13, 2005), recommended granting plaintiff's motion to remand in another comparable tax shelter case. After finding no substantial federal issue in the state law claims pleaded, Magistrate Judge Stuart concluded "furthermore opening the doors of federal courthouses to cases alleging these types of state law claims for giving faulty or fraudulent advice premised upon a misapplication of federal tax laws would inundate the federal courts with otherwise garden variety state law claims. Id. at 16.

In sum, the undersigned agrees with the reasoning set forth in Sheridan and Maletis. The substantial and contested issues in this case are state law claims of fraud, negligence, breach of fiduciary duty, and the like. The fact that those claims may touch upon questions of federal tax law does not present an actually disputed and substantial federal question. Moreover, remanding the case to state court is "consistent with congressional judgment about the sound division of labor between state and federal courts governing the application of Section 1331." Grable, 125 S.Ct. at 2367.

## CONCLUSION

For the foregoing reasons, it is respectfully recommended that this case be remanded to the Superior Court of New Jersey.

Dated: December 13, 2005

/s/ Mark Falk
**MARK FALK**
**United States Magistrate Judge**

Orig.: Clerk of the Court
cc: Hon. Harold A. Ackerman, U.S.D.J.
All Parties
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